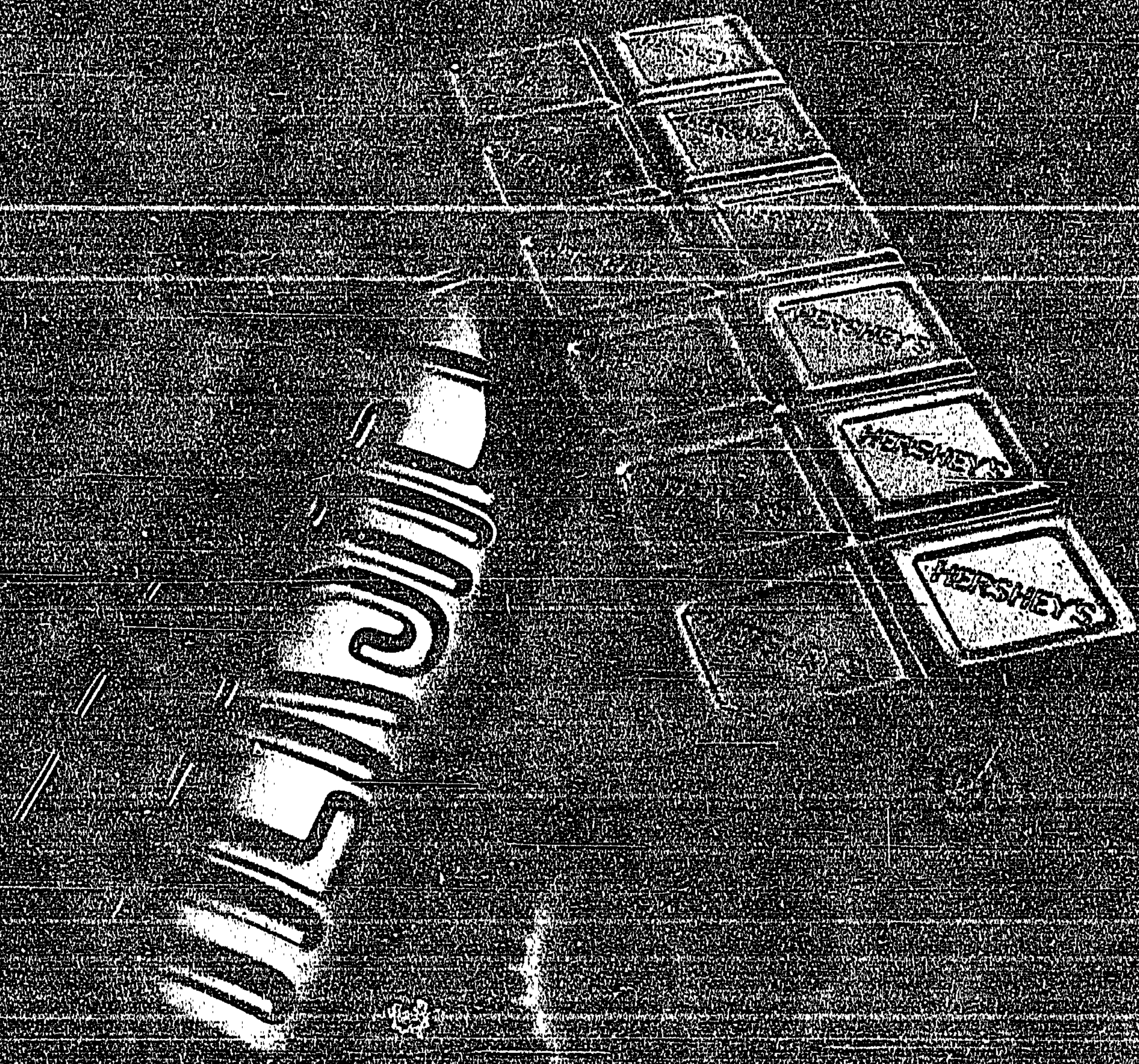
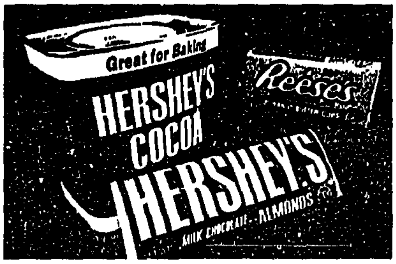
Hershey Foods Corporation / 1977 Annual Report

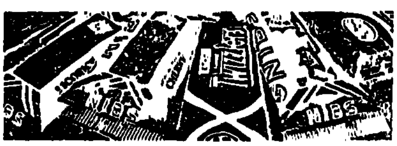


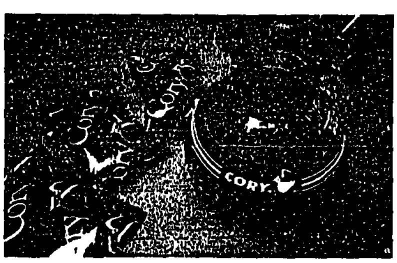

LICORICE
NibNax
LICORICE
Twizzlers
STRAWBERRY
Twizzlers
LICORICE FLAVORED
MEDICATED
COUGH
LICORICE FLAVORED
25% MORE CANDY
helps


Reese's
new
peanut butter
CHIPS
After Eight


San Giorgio
spaghetti sauce
NET WT 32 OZ (907.2 gms)







Hershey Foods . . .

is a major domestic producer of chocolate and confectionery products. Its Chocolate and Confectionery Division has plants in Hershey, Pa.; Oakdale, Calif.; and Smiths Falls, Ontario, Canada. In addition, this Division includes Y & S Candies Inc., a manufacturer of licorice-type candies, with plants in Lancaster, Pa.; Moline, Ill; Farmington, N.M.; Norwood, Mass.; and Montreal, Canada.

The Corporation has two principal subsidiaries—San Giorgio Macaroni Inc., a large regional producer of pasta products, with major plants in Lebanon, Pa., and Louisville, Ky.; and Cory Food Services Inc., Chicago-based manufacturer of coffee-brewing equipment and other appliances and provider of the nation's largest office coffee service plan.

Headquartered in Hershey, Pa., the Corporation employed 7,660 people and had 19,694 stockholders on December 31, 1977.

Hershey Foods Corporation
Hershey, PA 17033
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New Products

The introduction of new products is part of Hershey Foods Corporation's overall objective to become a major, diversified, international food and food-related company. To achieve this goal, the Company will introduce new products from three different sources: those developed internally through research and development activities; those developed externally through acquisition; and those developed through licensing and joint venture arrangements. The new products shown on these pages, representing all three sources, were introduced in 1977.

Y & S Candies

Hershey is proud to welcome Y & S Candies Inc., Westfield, N.J., as the newest member of its increasingly diversified company.

Y & S adds a wide variety of confectionery items to the Hershey Foods line. It manufactures licorice and licorice-type candies, cough drops, throat lozenges, hard candies and lollipops; and it is exclusive U.S. distributor for a number of European-manufactured confectionery and biscuit products.

Twizzlers, which are twisted strands of confection in licorice and other flavors, and Nibs and Nib Nax, which are bite-size pieces in licorice and cherry flavor, are its major brands.

Many Y & S brands enjoy wide customer acceptance and are among the leading brands sold in the United States and Canada. Combined with the proven strengths of Hershey's Chocolate and Confectionery Division, the Y & S product line has the potential for significant growth in market share, sales and profit.

Chocolate and Confectionery Division

During the last year this division launched four new products which emanate from a variety of sources.

Reese's Peanut Butter Flavored Chips, introduced nationally by the end of November 1977, can be used for a variety of baking purposes. Several years of research and testing by Hershey's Scientific Affairs Department went into the development of this unique product, manufactured with new processing techniques also developed by our own research people. A special strength of this new product is long shelf life.

Reese's Crunchy is a logical extension of the already famous Reese's Peanut Butter Cup line. Just as the name implies, Crunchy combines the two great tastes of Hershey's Milk Chocolate and peanut butter with something extra—chopped peanuts which have been added to the milk chocolate for those who like it crunchy.

Hershey's Golden Almond is a newly packaged specialty item for sale through quality department stores and gourmet-type outlets. A combination of Hershey's Milk Chocolate and almonds, Golden Almond is a direct descendant of Hershey's Toasted Almond Milk Chocolate, a specialty item formerly limited to retail distribution in the Hershey area.

After Eight, a wafer thin, dark chocolate covered creamy mint, is a Rowntree Mackintosh of England, Ltd. product which Hershey Foods is now marketing in several areas under a licensing agreement. After Eight is the leading chocolate covered mint in Canada, the United Kingdom, Germany and several other countries.

Cory Food Services

In 1977 Cory introduced the first full line of heat bank brewers to serve its office and institutional coffee market. These Generation II Heat Bank Brewers offer many advantages over conventional brewers.

Fresh water flows directly from tap to heat bank—a channeled aluminum casting with a built-in heating element. The water heats as it flows along the channels. Thus the inevitable lime formation is confined to the heat bank surface which can be delimed easily on site.

Water is never stored in a tank and never has the opportunity to become stale. Heat bank brewers are also easier to install and service and can provide hot water almost instantly.

This new line, created by Cory's own research and development team, has a brewer to fit every size and type of operation, every peak hot beverage need, and every coffee station requirement.

San Giorgio Macaroni

San Giorgio's new Spaghetti Sauce, with and without meat, occupies a virtually unique position in the market. Unlike some other leading brands, San Giorgio's products are naturally thick and contain no thickener or flavor enhancers. The sauces were developed in Hershey's research laboratories.

Introduced to the Philadelphia market in October 1977, the sauces achieved 100 per cent distribution within three weeks. At the beginning of 1978, distribution was begun in the Central Pennsylvania market, and plans call for eventual introduction in all San Giorgio market areas.

1977 Highlights

	1977	1976	% Change
Net sales from continuing operations	$671,227,000	$601,960,000	+11.5
Income from continuing operations	$ 36,031,000	$ 43,685,000	−17.5
Income from discontinued operations	$ —	$ 1,112,000	—
Gain on sale of discontinued operations	$ 5,300,000	$ —	—
Net income	$ 41,331,000	$ 44,797,000	− 7.7
Net income per common share			
Continuing operations	$2.62	$3.18	−17.6
Discontinued operations	—	$ .08	—
Gain on sale of discontinued operations	$ .39	—	—
Net income per common share	$3.01	$3.26	− 7.7
Dividends per common share	$1.14	$1.03	+10.7
Cash dividends paid	$ 15,251,225	$ 13,736,454	+11.0
Capital expenditures	$ 27,535,000	$ 20,722,000	+32.9
Stockholders' equity	$259,668,000	$233,529,000	+11.2
Equity per common share at year end	$18.91	$17.02	+11.1
Outstanding common shares at year end	13,730,288	13,720,186	—
Market prices of common stock—range during: First Quarter	19½–22⅜	18½–23¼	
Second Quarter	18¼–20⅞	20 –27	
Third Quarter	17⅞–21⅛	20 –27½	
Fourth Quarter	16⅝–20	18⅝–22½	

Quarterly dividends of 28¢ per share for the first three quarters and 30¢ per share for the fourth quarter were paid on common stock in 1977 compared with 25¢ per share for the first three quarters and 28¢ per share for the fourth quarter for 1976.

Letter to Stockholders:


Harold S. Mohler


William E. C. Dearden


Richard A. Zimmerman

We are pleased to report record sales, near record earnings, and improvement of the financial strength of the Company in 1977. Importantly, these achievements were realized in a highly challenging business environment both in terms of unprecedented high cocoa and coffee bean costs and an exceptionally competitive retail marketplace.

Sales advanced to a new high of $671,227,000, up 11.5% over 1976. Consolidated net income from continuing operations was $36,031,000, down 17.5% from the record 1976 results. During the year the company also realized a nonrecurring gain of $5,300,000 on the sale of our almond ranches in California. Thus, the total consolidated net income for the company was $41,331,000, or $3.01 per common share. This represents the second highest profit ever recorded by our company and, we believe, must be regarded as a very respectable performance in view of the extreme turmoil within our business and industry this past year.

The Board of Directors voted on October 27 to increase the cash dividend on the common stock to an annual rate of $1.20 per share. This increase was deemed warranted in view of the company's favorable long term prospects and its strong financial position. It is also in keeping with our philosophy of providing an appropriate return to our stockholders while also maintaining the financial strength of the company through a sufficient reinvestment of earnings.

One of the most crucial challenges confronting our Company today along with every other company in the U.S. food industry is the intensifying pressure brought by various groups which criticize the quality, nutrition and value of food products. Much of the evidence offered by these critics in support of their charges is, in our opinion, not well founded in scientific fact. Often scientific discussion is mixed with emotional argument and individual value systems to produce an inconsistent and inaccurate picture of food products.

We believe the food industry in the U.S., from grower to manufacturer to wholesaler to retailer, has created a system of food production and delivery that is unequalled in the world.

In terms of product quality, nutrition, variety and convenience, the products of the industry are of the highest quality and are available to the consumer at prices that are the least burdensome, in terms of standard of living, of food prices in all the developed countries of the world.

We are proud of the record of the U.S. food industry and the role of our company in supplying quality products to the American people at reasonable prices. Hershey's products do not contain, by themselves, a complete complement of daily nutritional requirements. However, our products, which contain the finest ingredients and are produced in modern facilities, are nutritious as well as tasty.

Consumers of our products are eating foods which have nutritional value and also provide an enjoyable experience. This concept is tested every day by the millions of people who purchase and consume our products. Their continued loyalty proves to us that, given appropriate responses in the food and nutrition policy debate, industries such as ours will continue to prove that the providing of quality products will be the ultimate test of consumer judgment. This has been a fundamental premise of our business since its inception and will continue to be so in the future.

Another important area of concern is the impact of commodity prices on our operations, and, over the years, first as a chocolate manufacturer and more recently as a producer of various food products, we have had to cope with some very volatile commodity markets.

Several years ago sugar prices rose to unprecendented—and unsustainable—heights. More recently coffee prices advanced by more than 600 percent but have now retreated significantly.

The most challenging of all commodity markets for us has, of course, been that of cocoa beans. Unusually dry weather conditions in West Africa (where two-thirds of the world's cocoa is grown) caused the past several crops to be abnormally low. This condition, together with a pattern of steadily increasing consumption over the past ten years, caused demand for cocoa beans to exceed supply and prices escalated. Unfortunately for consumers, this rise was far beyond that warranted by the rather

small deficits in supply which resulted. The present world crop appears to be of more normal proportion and market prices have recently declined significantly but still are higher than any annual average prior to 1977.

We continue to be concerned about the prospects for increased supplies of cocoa beans. Recent high prices for this commodity have stimulated production in the more progressive of the growing countries. They have also created new and renewed interest in cocoa in such countries as Malaysia, Costa Rica, and New Guinea. In West Africa, the Ivory Coast is taking vigorous action toward its stated goal of becoming the leading producer in that area of the world.

Through our participation in the American Cocoa Research Institute, we are working to encourage increased production—and, more importantly, productivity of cocoa in this hemisphere. This is being done through research aimed toward the development of high-yielding, disease-resistant hybrid cocoa trees and by encouraging the dissemination of information on better growing practices to the cocoa farmers.

As a company, we have recently entered into several joint ventures in cocoa growing—the newest being in the Central American country of Belize (formerly British Honduras). Through these ventures we hope to show that high quality cocoa beans can be grown profitably by using techniques available to the average farmer, thereby greatly increasing his productivity. We are encouraged by the results obtained to date and by the interest we have stimulated in persons from all parts of the world who see the possibilities for profit in growing this commodity.

For the company as a whole the objective in our strategic planning is to become a major diversified international food and food-related company. We are currently working toward this objective in four related but separate endeavors:

- To capitalize on the considerable growth potential of our existing brands and products in current markets.
- To introduce new products in the U.S. market, products developed internally as well as from licensing agreements and joint ventures.
- To expand in new markets, both international markets and new segments of existing markets.
- To make acquisitions and other types of alliances, both in the U.S. and elsewhere in the world.

Y & S Candies Inc., a major producer and distributor of licorice-type candies in North America, was acquired on November 30, 1977. This 140-year old company adds a new quality product line of non-cocoa base products to the company. We believe there is significant potential for growth of the Y & S products in conjunction with the proven strengths of Hershey's Chocolate and Confectionery Division.

In 1977 the company purchased 20 percent of the voting shares of AB Marabou, the leading Scandinavian confectionery company located in Sweden. Our investment in Marabou facilitates, for both companies, the exchange of technological information and the pursuit of the development and introduction of new products in the confectionery industry.

In order to sustain and increase the sales growth of existing brands, as well as new product introduction, we plan to spend record amounts for advertising and sales promotion. Our capital expenditures in 1978 will exceed the $27.5 million spent this past year. These funds will be spent primarily on additional production equipment and maintenance of our plant facilities as first-class food processing plants. Certain expenditures will also be made for environmental improvements, a new technical center and energy efficiency improvements.

We have commented throughout our letter concerning the various challenges confronting our business in 1977. Of particular interest and certainly great importance to our company is the ever-increasing role of government and regulatory agencies in our business. As a major consumer food company in the United States, we must be alert and sensitive to the various legislative and regulatory programs that affect our business.

We need to position ourselves so that our company can intelligently and in a timely fashion perceive new government programs that may impact upon our business. We must express our point of view on relevant issues and respond appropriately to the laws and regulations of our government. In order to increase the effectiveness of our government relations program on the federal level, we are opening a permanent office in Washington, D.C. This office and our government relations staff both in Washington and Hershey will aid us in the important areas of information exchange with government.

It is especially important that we cite the diligence, industry and loyalty of our employees at all levels without whom our accomplishments and growth would be impossible. We sincerely thank them for their performance in 1977. We are confident their continued dedication will help to bring even greater achievement to Hershey Foods Corporation in the future, thus providing opportunities for personal growth toward their career objectives.

H. S. Mohler

Chairman of the Board

Vice Chairman of the Board
and Chief Executive Officer

President and Chief Operating Officer

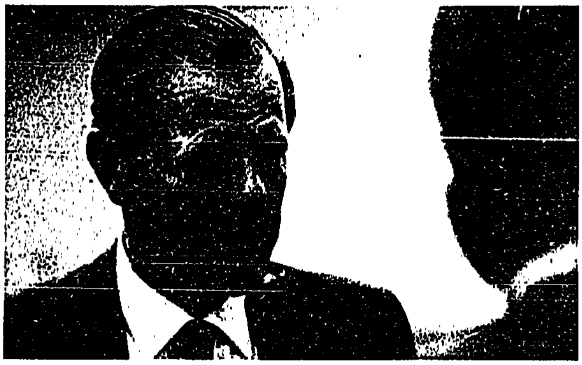
Board of Directors

Samuel A. Schreckengaust, Jr.
Vice President and
General Counsel

John C. Jamison
Investment banker, Partner
Goldman, Sachs & Co.

Philip A. Singleton
President
Singleton Associates International

Julian Hemphill
Director of Cocoa Bean Purchases



Louis C. Smith
Vice President
Engineering

John C. Suerth
Chairman and Chief Executive Officer
Gerber Products Company

Richard L. Uhrich
Vice President and
Secretary

Messrs. Mohler, Dearden
and Zimmerman are
pictured on Page 2.

Chocolate and Confectionery Division

	1977	1976
Sales (in millions)	$586.9	$526.8
% Change	+11.4	
Operating Income (in millions)	$ 69.8	$ 85.7
% Change	−18.6	

The figures above relate to continuing operations only.

Sales in the Chocolate and Confectionery Division again reached record highs, exceeding the 1976 performance by 11.4%. Operating income in the division was down 18.6%, primarily because of record costs of the major raw material, cocoa beans.

Price increases and productivity gains offset some, but not all, of the higher costs of 1977. Bar weight reductions resulted in a drop in tonnage produced.

Products

All but two confectionery brands contributed to the significant sales increases of 1977. Up substantially were Hershey's Milk Chocolate bars, Hershey's Milk Chocolate with Almonds bars, Hershey's Kisses, Kit Kat, Reese's Peanut Butter Cups, Hershey's Miniatures and Rolo. In addition, two new products —Reese's Crunchy and Hershey's Golden Almond—were also factors in the confectionery sales gain.

Golden Almond is especially noteworthy because it represents Hershey's entry into the specialty market. Previously offered only in the immediate vicinity of our plants as Hershey's Toasted Almond Milk Chocolate, this is now being distributed in quality department stores and gourmet-type outlets.

Also noteworthy was our new thrust into the market for products especially designed for fund-raising projects of the type in which scouting and school groups participate. Five of our bars are now offered in special weights and packaging in this market, and sales in 1977 were more than double those of 1976.

Rolo, first introduced in 1971 as an import from England, has been very successful and is now being produced in our plant in Hershey.

In retrospect, our move in late 1976 to a standard bar which was priced by most retail stores at 20¢ plus subsequent weight reductions necessitated by abnormally high cocoa bean prices, met with encouraging consumer acceptance. Although the confectionery industry failed to grow, our share of market increased considerably.

Sales of our grocery products were significantly higher. As in the case of confectionery products, however, tonnage was down. Higher prices did result in some consumer resistance.

Outstanding success was achieved by a new grocery product—Reese's Peanut Butter Flavored Chips. Though this product was not introduced until mid-year, it has already reached impressive sales levels.

Advertising expenditures were higher in 1977 and can be expected to increase further in order to strengthen our current marketing programs.

On December 16, we announced appointment of a second advertising agency—Doyle Dane Bernbach, Inc., whose initial brand assignments include Mr. Goodbar, Kit Kat, and Hershey's Syrup. Ogilvy & Mather, whom we appointed in 1969, will continue to handle the major share of our brands.

Raw Materials

The price of cocoa beans—the major raw material of the Chocolate and Confectionery Division—continued its meteoric rise during much of 1977. The average spot price of Ghana cocoa beans in 1976 was 46 percent higher than in 1975; for 1977 the average was twice that of the previous year, reaching an all-time high of $2.60 per pound in September.

Weather conditions in West Africa, where two thirds of the world crop of cocoa beans is grown, improved during the past growing season, and harvests are now forecast to be considerably better than the previous year. This, together with a decline in consumption caused by high prices, has recently brought about a considerable reduction in prices from the record highs, but they are still well above historic levels.

A prolonged period of dry weather last summer in several of the West African countries has caused harvests to be six to eight weeks later than normal. This compounded the already low stock position in many of the consuming countries and kept prices high through the end of 1977. Heavy shipments during the past two months have alleviated this tight situation and caused prices to decline.

The year 1977 witnessed significant government intervention in the sugar market which resulted in increased prices. In response to the domestic producers' requests for support due to depressed price levels in early 1977, Congress passed legislation which guarantees a

minimum price of 13½ cents per pound raw value, which is an increase of approximately 30% to 35% against the then prevailing prices. The Administration has imposed certain duties and fees to realize the 13½ cent level; but, unfortunately, these procedures have resulted in prices exceeding this target floor price.

The U.S. has announced its intention to become a member of the International Sugar Agreement. This position by our government signals a new posture with respect to international commodity agreements which allegedly will provide more orderly pricing mechanisms in the future.

Milk prices remained stable throughout 1977 due principally to abundant supplies and government supported price levels. Almond and peanut prices were approximately 10% over 1976 prices. These, too, are government supported. Prices for milk, almonds and peanuts in 1978 are expected to increase in line with general price levels in the economy.

Hershey Chocolate of Canada

While sales were higher and operating income was the best recorded since operations were begun in 1963, consumer resistance to the 25¢ bar has remained a deterrent to Hershey's performance as well as that of the entire Canadian chocolate and confectionery industry.

Sales of bar goods were down throughout the industry, including Hershey's. As in the United States, however, new efforts in the fund raising bar market have proved successful, and a special division in Canada which is handling this program had a strong showing for Hershey in 1977. Grocery products showed positive gains with Instant, Syrup, Chips, and Cocoa all up in sales.

The Canadian operation of Y & S Candies and its early 1978 acquisition of a broker-distributor in Ontario will provide additional opportunities for operational efficiencies and growth in Canada.

Y & S Candies

Y & S Candies, one of the nation's oldest and largest manufacturers and distributors of licorice and licorice-type candies in North America, brings to Hershey further diversification into non-chocolate confections.

Twizzlers, Nibs, and Nib Nax are major brands manufactured primarily from corn syrup, flour, sugar, and flavorings.

Cough drops are manufactured and distributed under the HB Hospital Brand; and Helps, which are pellet-shaped, licorice throat lozenges, are imported and marketed by Y & S. This company also manufactures hard candies and lollipops under the Flav-A-Drops and Flav-A-Pops trademarks.

In addition, Y & S is the exclusive U.S. distributor for Geo. Bassett & Co., Ltd. of Sheffield, England, the manufacturer of Allsorts Candies and other licorice-type confections. The company is also the exclusive U.S. distributor of Toggenburger Wafers, a delicate wafer product in vanilla, lemon, peanut butter, chocolate and hazelnut flavors, made by Kägi Sons of Toggenburg, Switzerland.

Among the most important of the flavors used by Y & S are licorice powder and anise oil which are purchased from foreign and domestic processors who obtain them from Eastern Mediterranean and East Asian sources. Overall, prices for this company's raw materials declined in 1977, and Y & S is confident of continuing availability of its raw materials at relatively stable prices.

In 1977 Y & S completed a new, major manufacturing plant in Lancaster, Pa., and phased out a major but antiquated plant in Brooklyn, N.Y. It has other plants in Montreal, Quebec; Moline, Ill.; Farmington, N.M.; and Norwood, Mass.

Other Food Products and Services

	1977	1976
Sales (in millions)	$ 84.3	$ 75.1
% Change	+12.3	
Operating Income (in millions)	$ 4.5	$ 5.0
% Change	−10.0	

San Giorgio Macaroni

Stable prices of durum wheat helped make 1977 a most encouraging year at San Giorgio, although operating income was down slightly.

The favorable costs plus operating efficiencies enabled this company to set lower prices for its products, in turn boosting sales across all product lines in all sales categories. It also enabled San Giorgio to invest more heavily in sales and marketing, particularly in its newest target area, the New York City market.

Excellent performance in institutional sales and several product lines such as sauce, noodles, spaghetti, and lasagne gave San Giorgio a good increase in case volume sales while the industry total was flat.

Two new products—Light 'N Fluffy Noodles, enriched twists of whole egg noodles; and Spaghetti Sauce, a naturally thick sauce containing no thickeners or flavor enhancers—were introduced in late 1977.

Early success with these products, continuing efficiencies at our plants in Lebanon, Pa. and Louisville, Ky., plus prospects for relative stability in commodity prices provide a solid basis for further progress at San Giorgio in 1978.

Hershey Foods Corporation marked with sadness the passing of Jerome V. Guerrisi, a vice president and a son of San Giorgio's founder, on October 13, 1977.

Cory Food Services

First half results were affected markedly by extraordinary increases in green coffee bean prices, which reached $3.265 per pound in April before leveling off for several months and then declining to $1.87 by year end. The late decline helped relieve pressure on the selling prices of Cory's Coffee Service Kits, which have increased substantially over 1976.

Service remains the keystone of Cory's business, and its Office Coffee Service program, under which the company provides brewing equipment, product and maintenance while the client supplies daily service.

The impact of coffee prices was felt also in the products division, where equipment sales were soft. Cory further consolidated manufacturing operations at its Chicago plant and discontinued the sale of most consumer items.

Of special significance in 1977 was the introduction of a full line of heat bank brewers for the firm's office and institutional markets. These Generation II Heat Bank Brewers eliminate storage tanks and exposed heating elements. Fresh water flows directly from tap to heat bank, a channeled aluminum casting where heating takes place. They are faster, more efficient, use less energy, and require less maintenance than conventional tank brewers. We are confident they will keep the company at the forefront of the coffee service industry, in which it pioneered, as well as in the field of institutional equipment.

This new line created by Cory's own research and development staff, probability of more favorable green coffee bean prices, and a sound team of management and employees have generated much optimism regarding Cory's 1978 results.

Corporate Research and Development

In 1977 several new products developed within the Corporation were introduced to the marketplace. Included are Reese's Peanut Butter Flavored Chips in the Chocolate and Confectionery Division plus a spaghetti sauce and a twisted noodle product in the Pasta Division.

Earlier in 1977, a high-quality, protein-fortified pasta was made available by San Giorgio to the school lunch program. A high-nutrition product now being used in school lunch programs, this may play an important role in the consumer market as consumer concerns on nutrition expand in the coming years.

The research and development work that has led to these new products has provided Hershey Foods Corporation with new technologies that will be exploited in the coming years to provide additional new products.

Work continues on the evaluation of new alternate ingredients, particularly alternate fat ingredients that have the quality and characteristics of cocoa butter. The cocoa butter alternative fat made available by Procter & Gamble was studied extensively in 1977, and evaluations in manufacturing and acceptance have been completed with anticipation that final regulatory clearance will be available by mid-1978.

A significant change in the production of our basic chocolate products was initiated in 1977 with the completion of a major process modification enabling more exact control of composition and a more rapid processing from raw materials to finished product.

The Corporation continues to improve the major quality control and quality assurance programs throughout all of its operating units. The Product Excellence Program, initiated in 1976, has proven to be an effective tool for directly involving the manufacturing staff in maintaining quality of product during processing, packaging, and distribution.

International Affiliations

Hershey owns 22½ percent of Chadler Industrial da Bahia S.A., a Brazilian company which converts cocoa beans to various semifinished products, including chocolate liquor and cocoa butter. In 1977, Chadler, like other cocoa bean converters, benefited from the precipitous rise in world prices for their products. Chadler is currently expanding capacity and modernizing its plant.

Nacional de Dulces, S.A. de C.V. is a joint venture with Anderson, Clayton & Co., S.A. (ACCOSA) in Mexico. This company produces chocolate products under the Hershey brand as well as other confectionery products for the Mexican market. Nacional de Dulces was able to make a strong domestic showing in sales, earnings and market share in 1977.

As mentioned elsewhere in this report, Hershey has acquired 20 percent of the voting shares of AB Marabou, the leading Scandinavian confectionery firm, in Sweden.

Investor Relations

In 1976 a survey was undertaken to determine the extent to which awareness and understanding of Hershey Foods Corporation existed in the investor community. This survey clearly established an overwhelming awareness of our brands and products, particularly chocolate and confectionery, but only limited knowledge of the Corporation.

Beginning in the latter part of 1976, increased emphasis was placed on our investor relations program with the objective of communicating more openly and effectively with the investment community in order to generate awareness of the Corporation and its plans for growth and development.

During 1977, the primary thrust of this program centered upon various informational meetings in major cities throughout the United States and Europe. Key members of our senior management participated in these meetings. The audience consisted primarily of representatives from both retail and institutional investment firms as well as commercial and investment bankers.

Energy

Though food manufacturing is not energy intensive, the food industry, because of its size, is one of the ten largest energy users in the U.S.A.; thus, increasing attention can be expected from the regulating agencies.

Hershey Foods uses natural gas, various grades of fuel oil, and electricity as sources of energy. Natural gas suppliers have informed us of an improvement of the supply situation, and no disruptions due to gas curtailments are anticipated in 1978. We are also forecasting ample supplies of fuel oil for the next several years, though we do maintain reserve storage available to each plant. Electricity remains attractive, despite increasing cost, because of its cleanliness and versatility.

Our ongoing conversion of equipment to alternate fuel capability and our conservation programs, which have contributed to significant energy usage reduction, have improved our flexibility in coping with this nation's energy crisis. Although energy rates have been accelerating rapidly in recent years, the total impact of energy costs on our operations is not significant.

Government Relations

The area of government relations has become an increasingly active element in the Corporation's activities. We need to be aware of general governmental developments at the national, state and local levels which may impact on our business, and we have an obligation to inform appropriate government officials of facts which may aid them in reaching informed and reasoned decisions on legislation and regulations.

Over the last year particularly strong forces have been attempting to limit the sale of confectionery products under some circumstances. These activities have been undertaken at all levels of government. In several instances we have explained the nutritional profiles of our products and their place in the diet in order to point out to governmental authorities the popular misconceptions which are so prominently maintained in the media and elsewhere. This has been effective in counteracting damaging legislative proposals in some cases. A further statement concerning this problem

can be found on page 10 of this report.

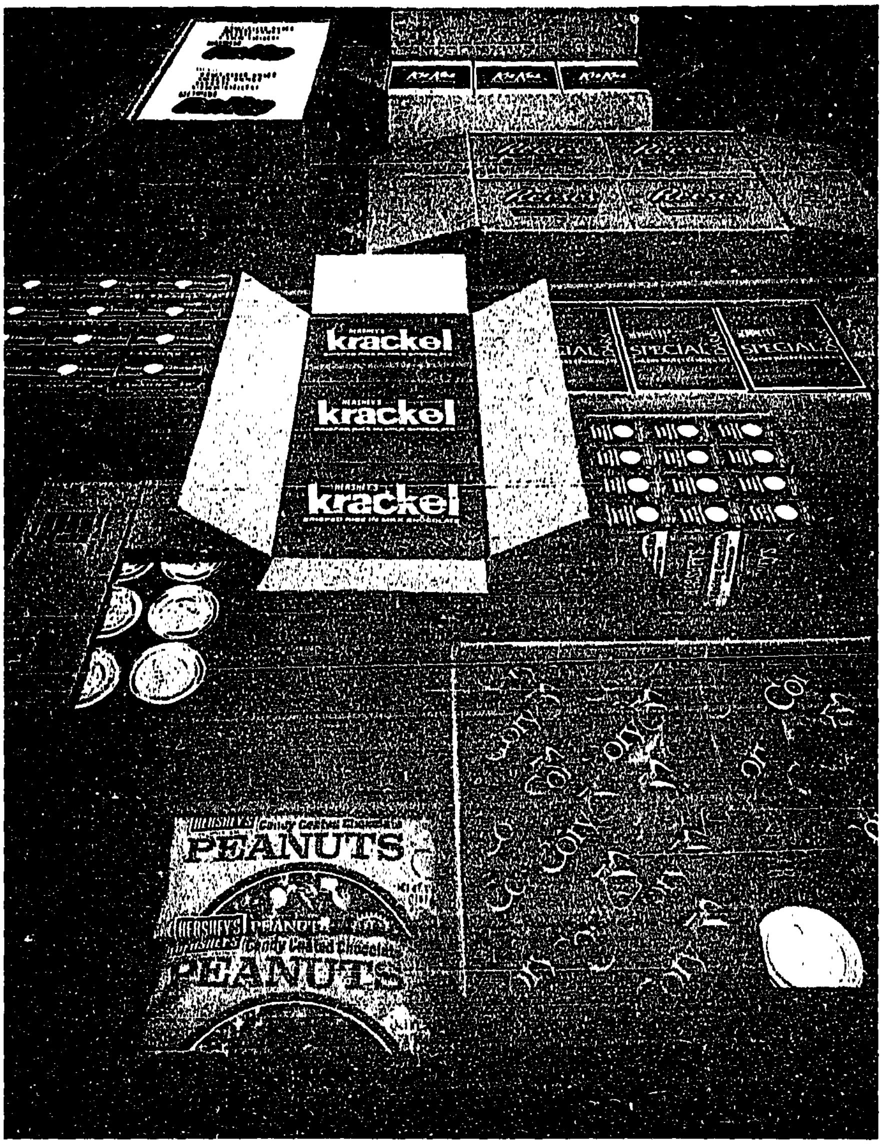
We continue to believe that it is essential for the Corporation to be involved in general business-government issues, as well as tax reform and regulatory agency developments in order to ensure that we are not placed at a competitive disadvantage in our industry or in the world.

Human Resources

We are very much aware of our continuing need for competent employees in order to meet our strategic objectives. To assist in meeting this need, we initiated a formal program of human resources planning in 1977.

We have also launched a longer range planning program designed to identify the appropriate organizational structure, skills, and employee training and development needs required for the next three years. An example of the latter is a series of workshops scheduled in 1978 which will train managers in the various financial concepts and techniques which they need to know in order to be more effective in the performance of their job responsibilities.

Critical to the overall planning and development program has been the initiation of the new Corporate Management Succession Process. The major thrust of this activity has focused on the identification and development of candidates for our key management positions, and we have utilized a top management committee, chaired by the Chief Executive Officer, to provide the necessary guidance in this effort.



Good Nutrition Makes Good Sense

Everyone agrees that good nutrition makes good sense. But what is good nutrition? Nowadays many people are readily willing to answer this question, but many of their answers are contradictory.

While we do not advertise our chocolate products as especially nutritious foods, they do have nutritional value and do contribute to the overall diet since they are composed of such food ingredients as milk, various nuts, chocolate and sugar.

Nearly all Hershey's Chocolate and Confectionery Division products have nutrition information printed on their labels. This practice was begun voluntarily in 1973, and to date we are the only manufacturer in the chocolate and confectionery industry to provide this consumer service. Our effort to convey this information is one clear indication of Hershey's concern for good nutrition and our respect for the consumer's right to know.

Good nutrition comes from a balanced diet; one that provides the right amounts and the right kinds of proteins, vitamins, minerals, fats and carbohydrates. The chart on the next page provides an interesting basis of comparison between Hershey Foods' products and other snack items commonly cited as "more nutritious."

Chocolate and confectionery products and other sugar containing snacks have been coming under attack recently. They are accused of being "empty calorie" or so-called "junk" foods.

We all have substantial caloric needs. At Hershey Foods we believe obtaining the right amount of calories is especially important for active, growing children. Calories come from nutrients; namely carbohydrates, fats and proteins. Our products supply these nutrients and do contribute to good nutrition.

Throughout the world, carbohydrates are the largest single component of the diet. In the United States, about half of all calories (i.e., energy) are provided by carbohydrates commonly referred to as sugars and starches. As far as the body is concerned, all carbohydrates must be reduced to simple sugars before they can be used. Once sugars and starches reach the stomach, their dietary origin is lost. It makes no difference whether they come from fruits, vegetables, milk, honey, or Hershey Bars—before entering the blood stream, they are all alike.

Sugar is currently bearing the brunt of the attack from a variety of sources. Since sugar is a significant component of many Hershey Foods' chocolate and confectionery products, we are naturally concerned about these attacks and the types of evidence used to support them.

At present sugar is not linked in substantive research to the variety of health problems usually mentioned in this context. As for dental caries, a complex issue, there is evidence that sugar, both naturally occurring and added, plays a role. On the other hand, a number of studies in dental literature show that chocolate, especially milk chocolate, does not cause an increase in dental caries.

Researchers report that milk chocolate has a high content of protein, calcium, phosphate and other minerals, all of which have exhibited positive effects on tooth enamel. In addition due to its natural fat (cocoa butter) content, milk chocolate clears the mouth quickly in comparison to some other foods. These factors are thought to be responsible for making milk chocolate less likely to cause dental caries than certain other foods.

The American public is being inundated with numerous attacks on sugar and the role it plays in the diet. Many assertions are made on a partial understanding of the facts or without substantiating research.

Unfortunately the crusade against sugar containing products is well underway despite a lack of adequate, factual support. Federal, state, and local governmental bodies have entered the fray, and considerable media interest has been generated. We fear that great misunderstanding will be created before the issue is resolved, although as a company and an industry, we are trying to raise the information level on all fronts.

One aspect of this very complex situation is the role the Federal Trade Commission has been asked to play regarding the advertisement of products containing sugar. At the present time, the FTC is considering various means of limiting our industry's ability to advertise its products.

Hershey Foods has and will continue to oppose any attempt to limit its right to advertise. We believe we have the right to advertise to all of our audiences and we do not think our advertising has been out of balance. In 1978, less than one-third of all our advertising impressions will be received by children.

Hershey Foods has always been concerned about the content of its advertising as well as the type of programs it supports. We have helped in the development of voluntary codes through the Children's Review Unit of the National Advertising Board, and our ads are constantly reviewed by child psychologists and public affairs specialists to make sure they are not misleading and cannot be misunderstood.

Our standard bar line, which accounts for the majority of advertising expenditures, represents an inexpensive group of products. We feel that children can be appropriately informed about them, especially in light of their nutritional value and the parental approval they have received for generations in the United States. We believe we have the right to remind consumers of our products and to inform new consumers about products their parents have used, enjoyed, and approved.

Perhaps the most paradoxical aspect of this issue is the fact that chocolate and confectionery consumption in the United States is not excessive, representing only about one per cent of total food intake. What's more, consumption of these foods has not increased in the last 40 years. Since mass media advertising did not really come into being until the 1950's, it is evident that television advertising has not contributed to increased consumption of chocolate and confectionery products. As far as our industry is concerned, however, advertising has simply fostered competition.

The so-called "junk" food issue in all its complexity will continue to be an important challenge to Hershey Foods Corporation. We shall stand firmly in our position that Hershey's products are mixtures of ingredients which inherently have nutritional value. Hershey has manufactured chocolate and confectionery products of the highest quality for over 80 years. We are very proud of these products and the role they play in the lives of people throughout the world.

Nutritional Value per Serving of Various Foods[2,3]

	A Milk Chocolate	B Mr. Goodbar	C Reese Cup	D Ice Cream	E Saltine Crackers	F Graham Crackers	G Cheese/Peanut Butter Crackers	H Apple	I Dried Dates
Serving size	1.05 oz	1.3 oz	1.2 oz	8 fl oz (1 cup)	1 oz	1 oz	1.5 oz	3¼ in. diam.	1.4 oz
Calories	160	210	190	260	120	110	210	120	120
Protein (grams)	2	5	4	6	2	2	6	0	1
Carbohydrate (grams)	17	18	18	28	20	20	24	30	29
Fat (grams)	10	13	11	14	3	2	10	1	0
Vitamin A[1]	*	*	*	*	*	*	*	2	*
Vitamin C[1]	*	*	*	*	*	*	*	10	*
Thiamine[1]	*	2	*	2	*	*	*	2	2
Riboflavin[1]	4	4	2	15	*	4	2	2	2
Niacin[1]	*	8	8	*	*	2	8	*	4
Calcium[1]	6	4	2	20	*	*	2	*	2
Iron[1]	2	2	2	*	2	2	2	2	6

*Contained less than 2 percent of the U.S RDA of these nutrients

[1]Vitamins and mineral levels are expressed as a percentage of the U.S. RDA

[2]Information for foods other than Hershey products derived from U.S.D.A. Handbook No. 456 *Nutritive Value of American Foods*

[3]Items A, B, & C, according to at least one state's legislators' list, would be included in a "low-nutritious" category
Items D through I are identified on that list as nutritious food

Management's Discussion and Analysis of the Summary of Operations

The financial comments relate to the current two year comparative results of operations as well as the five year financial summaries contained on pages 14 and 23.

During the five years ended December 31, 1977, Hershey Foods Corporation experienced growth in consolidated net sales. Income from continuing operations showed a continued upward trend except for 1977 when cocoa bean costs reached unprecedented levels. Income in 1973 was severely depressed when Federal price controls, which did not allow a timely pass-through of cost increases, adversely affected earnings.

1977 Compared with 1976

Consolidated net sales from continuing operations increased by $69,267,000 or 11.5% to $671,227,000 compared with the same period in 1976. The Chocolate and Confectionery Division accounted for most of the increase in sales. Sales of Other Food Products and Services also increased over 1976. Both the pasta division and Cory sales were higher than 1976 reflecting increased tonnage for pasta and higher selling prices for Cory.

In December of 1976 the Chocolate and Confectionery Division increased prices on many items and increased weights of its standard bars. As a result, these bars, which sold in most retail outlets for 15¢ in 1976, sold for 20¢ in 1977. While dollar sales increased because of higher selling prices, unit sales declined for this period.

Costs of cocoa beans, milk, peanuts and almonds were higher in 1977 compared with 1976. Raw material costs for sugar were slightly lower in 1977. To attempt to minimize the effect of the escalating cocoa bean prices during the year, the Chocolate and Confectionery Division implemented various other price increases and weight reductions on numerous products. Because of the substantial increase in cocoa bean costs for the chocolate and confectionery products, income was adversely affected since profit margins could not be maintained, and this, together with diminished unit sales, resulted in a decline in income from continuing operations.

During 1977, the Company reduced inventory quantities, primarily cocoa beans. This reduction resulted in a liquidation of LIFO inventory quantities carried at lower costs prevailing in prior years as compared with the cost of 1977 purchases, the effect of which decreased cost of goods sold by approximately $8,500,000 and increased net income by approximately $4,000,000 or $.29 per share. During 1977, cocoa bean prices reached unprecedented levels. The Company viewed the economic conditions causing this increase as temporary. Thus, the company's cocoa bean procurement strategy was to minimize, within operating needs, purchases of this commodity. As prices are so volatile, it is not uncommon for inventory levels to also fluctuate.

Selling, administrative and general expenses increased substantially in 1977 compared with 1976 because of increased promotion and selling expenses and higher consumer advertising. Another factor contributing to the increased costs was the expense associated with the acquisition of Y & S Candies. Additionally, the general rate of inflation has caused an increase in other costs.

The operations of Y & S Candies Inc., acquired in November, 1977, were adversely affected this year primarily because of the costs associated with the closing of the Brooklyn, New York plant; relocation to the new Lancaster, Pennsylvania manufacturing facility; and the merger.

As a result of an improved cash position in 1977 the Company had net interest income of $509,000 compared with net interest expense of $356,000 in 1976.

Income from continuing operations was $36,031,000 in 1977 in comparison with $43,685,000 in 1976 or a decrease of 17.5% reflecting the substantially higher cocoa bean costs and a decrease in unit sales which reduced profit margins.

Net income for 1977 reflects the gain on the sale of the real estate and operating equipment of L. D. Properties, which amounted to $5,300,000 after tax or $.39 per share. The assets were sold to Tenneco West, Inc. on June 30, 1977, for $20,000,000. Since the results of L. D. Properties were nominal in 1977, these amounts were included in continuing operations.

Accounts payable increased substantially at the end of 1977 compared with 1976 because of large deliveries of cocoa beans at the end of the year.

Other receivables decreased at the end of 1977 because of the sale of L. D. Properties and the resulting loss of almond sales at year end and lower raw bulk milk sales.

1976 Compared with 1975

Consolidated net sales from continuing operations increased by $25,795,000 or 4.5% to $601,960,000 in 1976 compared with 1975. The Chocolate and Confectionery Division accounted for much of the increase in sales with Other Food Products and Services being slightly higher than 1975. The pasta division remained at about the same dollar level as 1975, although poundage increased. Cory sales were higher than 1975 reflecting higher selling prices.

Sales dollars increased in 1976 compared with 1975 in spite of average selling prices being lower in 1976 than in 1975. The increase in consumer units sold exceeded the percentage increase in sales dollars and poundage also increased.

The Chocolate and Confectionery Division decreased selling prices and increased bar weights on selected items early in 1976. In December of 1976, the Division increased prices on many items and increased weights of its standard bars. As a result, these bars, which sold in most retail outlets for 15¢, now sell for 20¢.

With respect to raw materials, the cocoa bean market prices again escalated in 1976 and reached record highs while sugar prices declined compared with 1975. Nevertheless, the Division's costs in 1976 for cocoa beans and sugar were less than in 1975. In Other Food Products and Services, the most significant cost increase was incurred for coffee. Coffee prices continued to set new record highs. The cost of flour used in pasta products declined in 1976 compared with 1975.

Selling, administrative and general expenses increased substantially in 1976 compared with 1975, because of increased promotion and selling expenses and higher consumer advertising. Advertising costs were $13,330,000 in 1976 compared with $9,499,000 in 1975.

Interest expense declined in 1976 compared with 1975. This decline in

interest expense reflected an improved cash position resulting from increased cash flow from improved earnings.

Income from continuing operations was $43,685,000 in 1976 in comparison with $40,902,000 in 1975 or an increase of 6.8% reflecting greater increases in net sales than in costs and expenses.

Other receivables, as shown on the Balance Sheet, increased substantially at the end of 1976 compared with 1975. This was primarily because of increases in receivables resulting from increased sales of almonds grown by the Company's agricultural subsidiary, L. D. Properties; higher raw bulk milk sales; and increases in margin accounts for commodity futures.

Prior Years

Sales dollars of chocolate and confectionery products increased substantially, reflecting higher average selling prices in 1975 compared with 1974. There was also an increase in volume of consumer units sold in 1975 compared with 1974. However, the actual poundage sold in 1975 declined as a result of lower average bar weights of many of the chocolate and confectionery items. The Company experienced unprecedented escalation in virtually all raw material costs beginning in 1973 and continuing through 1974 and 1975. The most significant increases were incurred in sugar and cocoa beans for chocolate and confectionery products. Although market prices of cocoa beans and sugar receded in 1975 compared with the highs of 1974, the Company's average annual costs of these commodities were higher in 1975 than in 1974. In the case of Other Food Products and Services a significant cost increase was incurred for coffee, while the cost of flour used in pasta products declined in 1975 compared with 1974.

The operations of one of the Company's subsidiaries, Portion Control Industries, Inc., were discontinued in 1975. Losses from this operation were $1,433,000 in 1975 and $2,277,000 in 1974. In addition, the loss on disposal of this business was $4,898,000.

In 1974, a transition was made in chocolate bar prices to 15¢ from the 10¢ price that had been in effect since 1970.

For many years, a substantial portion of the Company's major raw materials, goods in process and finished goods have been stated at cost under the LIFO method. In 1974, the Company extended LIFO inventory accounting to sugar and certain packaging materials for its chocolate and confectionery products in order to match more realistically current costs against revenue and reduce the effect of inflation on earnings. The effect of the change was to increase cost of sales by $12,444,000 and decrease net income by $6,002,000 or $.44 per share in 1974.

In 1973, earnings were adversely affected by Federal price controls which did not allow a timely pass-through of costs. The situation was further aggravated since many of the Company's raw materials are agricultural commodities which were not covered by price controls and increased in cost during the year. The Company reduced inventory quantities, primarily cocoa beans, and this reduction resulted in a liquidation of LIFO inventory quantities carried at lower costs prevailing in prior years as compared with cost of 1973 purchases, the effect of which reduced cost of sales by $4,500,000 and increased net income by approximately $2,140,000 or $.16 per share in 1973.

Capital Additions

Capital additions in 1977 amounted to $27,535,000. Of this amount, depreciation provided $7,995,000. The Company spent $88,050,000 or an average of $17,610,000 annually during the past five years.

Dividends

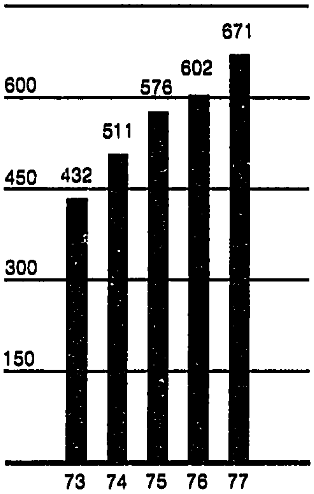
The Company completed its 48th year of uninterrupted dividends with the payment on December 15, 1977, of its 192nd consecutive quarterly dividend on the common stock. Cash dividends paid by the Company and Y & S Candies Inc., acquired in 1977 in a pooling of interests transaction, were $15,251,225 in 1977 and $13,736,454 in 1976. Dividends per share of Hershey's common stock were $1.14 in 1977.

Sales and Income by Class of Products*
(dollars in thousands)

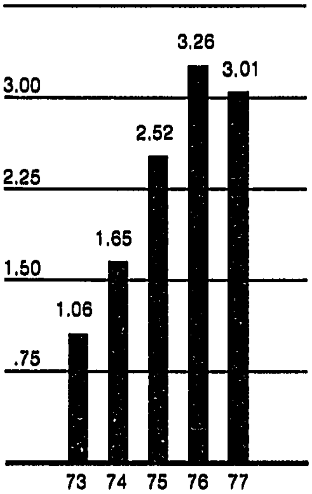
	1977 $	1977 %	1976 $	1976 %	1975 $	1975 %	1974 $	1974 %	1973 $	1973 %
Net Sales from Continuing Operations										
Chocolate and Confectionery Products	586,882	87	526,822	88	503,263	87	438,313	86	367,185	85
Other Food Products and Services	84,345	13	75,138	12	72,902	13	72,770	14	64,928	15
Total	671,227	100	601,960	100	576,165	100	511,083	100	432,113	100
Income from Continuing Operations										
Chocolate and Confectionery Products	69,834	94	85,688	94	83,551	96	50,269	95	30,912	91
Other Food Products and Services	4,528	6	5,005	6	3,549	4	2,664	5	2,982	9
Operating Income	74,362	100	90,693	100	87,100	100	52,933	100	33,894	100
Interest and Corporate Expenses not otherwise allocated—net	2,982		1,446		2,906		3,006		5,575	
Income from Continuing Operations before Taxes	71,380		89,247		84,194		49,927		28,319	

* Restated to include pooling of interests and continuing operations.

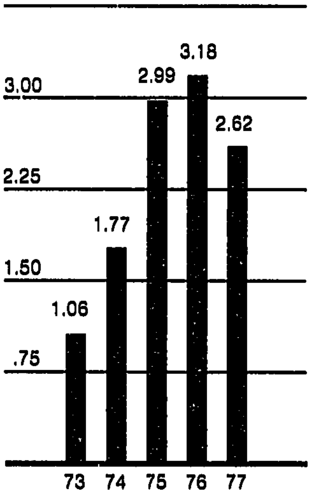
Net Sales from Continuing Operations
(dollars in millions)



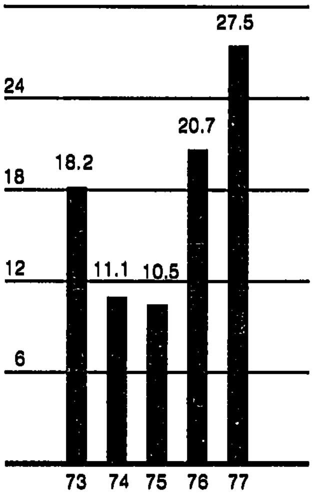
Net Income per Share
(dollars)



Income per Share from Continuing Operations
(dollars)



Capital Expenditures
(dollars in millions)



Consolidated Statements of Income and Retained Earnings

	For the Years Ended December 31	
	1977	1976
Net Sales	$671,226,799	$601,959,556
Costs and Expenses:		
Cost of goods sold (Note 1)	453,960,322	383,663,981
Selling, administrative and general	109,585,083	93,503,079
Shipping	28,816,271	27,649,942
Depreciation	7,994,778	7,538,977
Interest expense (income)—net	(509,263)	356,397
Total costs and expenses	599,847,191	512,712,376
Income from continuing operations before taxes	71,379,608	89,247,180
Provision for Federal and state income taxes (Note 3)	35,349,000	45,562,000
Income from Continuing Operations	36,030,608	43,685,180
Discontinued Operations (Note 2):		
Income from discontinued operations (less income taxes of $1,256,093)	—	1,112,489
Gain on sale of discontinued operations (less income taxes of $2,985,000)	5,300,000	—
Net Income	41,330,608	44,797,669
Retained Earnings at January 1	217,775,440	187,342,765
Deduct—		
Cash dividends	14,847,707	13,415,063
Dividends of pooled company prior to acquisition (including stock dividends of $628,540 in 1976)	403,518	949,931
Retained Earnings at December 31	$243,854,823	$217,775,440
Net Income per Common Share (Note 1):		
Continuing operations	$2.62	$3.18
Discontinued operations		
Income from operations	—	.08
Gain on sale of operations	.39	—
Net income	$3.01	$3.26
Cash dividends per common share	$1.14	$1.03

The accompanying notes are an integral part of these statements.

Consolidated Balance Sheets

Assets

	December 31 1977	December 31 1976
Current Assets:		
Cash	$ 7,980,073	$ 4,828,494
Commercial paper and certificates of deposit	109,258,432	52,646,821
Accounts receivable—trade (less allowances for doubtful accounts of $1,326,963 and $1,171,940)	35,756,496	29,258,505
Other receivables	4,885,797	15,187,334
Inventories (Note 1):		
Raw materials	28,135,679	31,394,665
Goods in process	6,805,500	7,730,739
Finished goods	27,008,347	27,178,130
	61,949,526	66,303,534
Prepaid expenses	1,371,785	1,647,433
Total current assets	221,202,109	169,872,121
Property and Equipment, at cost:		
Land	2,773,206	5,122,342
Buildings	67,903,794	62,531,258
Equipment	160,656,697	146,553,131
	231,333,697	214,206,731
Less—accumulated depreciation	88,163,676	84,957,494
	143,170,021	129,249,237
Goodwill	17,776,622	17,788,683
Other Assets:		
Investments (Notes 1 and 2)	8,094,663	2,597,020
Deferred almond ranch development expenses (Note 1)	—	4,830,473
Deferred coffee service location costs (Note 1)	1,502,096	1,851,240
Industrial Revenue Bond trust funds (Note 4)	876,797	1,890,188
Other assets and deferred charges	3,530,505	3,790,965
	14,004,061	14,959,886
	$396,152,813	$331,869,927

Liabilities and Stockholders' Equity

	December 31 1977	December 31 1976
Current Liabilities:		
Accounts payable	$ 55,650,125	$ 18,979,685
Accrued liabilities	14,154,177	14,577,451
Income taxes payable	13,345,174	13,751,404
Total current liabilities	83,149,476	47,308,540
Long-Term Debt (Note 4)	29,440,000	29,440,000
Deferred Income Taxes	23,895,836	21,592,762
Stockholders' Equity (Notes 1 and 6)		
Common stock, without par value— authorized 20,000,000 shares; outstanding 13,730,288 and 13,720,186 shares	13,730,288	13,720,186
Additional paid-in capital	2,082,390	2,032,999
Retained earnings	243,854,823	217,775,440
Total stockholders' equity	259,667,501	233,528,625
	$396,152,813	$331,869,927

The accompanying notes are an integral part of these balance sheets.

Consolidated Statements of Changes in Financial Position

	For the Years Ended December 31 1977	1976
Financial Resources Provided		
Continuing Operations:		
Net income	$36,030,608	$43,685,180
Depreciation	7,994,778	7,538,977
Deferred income taxes	4,824,708	1,313,933
Total provided from continuing operations	48,850,094	52,538,090
Discontinued Operations:		
Net income or gain	5,300,000	1,112,489
Depreciation	—	346,212
Deferred income taxes	(2,521,634)	(142,275)
Assets sold or held for disposal	9,238,814	(2,600,000)
Total provided (applied) from discontinued operations	12,017,180	(1,283,574)
Industrial Revenue Bond trust funds	1,013,391	769,229
Other	1,892,112	1,539,470
Total resources provided	63,772,777	53,563,215
Financial Resources Applied		
Cash dividends	15,251,225	13,736,454
Capital expenditures	27,534,857	20,721,801
Reduction in long-term debt	—	416,204
Increase (decrease) in investments	5,497,643	(104,739)
Total resources applied	48,283,725	34,769,720
Increase in working capital	$15,489,052	$18,793,495
Details of increase (decrease) in working capital		
Cash	$ 3,151,579	$ (4,219,547)
Commercial paper and certificates of deposit	56,611,611	6,446,498
Receivables	(3,803,546)	18,652,007
Inventories	(4,354,008)	(4,777,634)
Prepaid expenses	(275,648)	205,403
Net assets of discontinued operations at estimated realizable value	—	(4,013,000)
Loans payable within one year	—	270,609
Accounts payable	(36,670,440)	4,963,597
Accrued liabilities	423,274	(1,389,669)
Income taxes payable	406,230	2,655,231
Increase in working capital	$15,489,052	$18,793,495

The accompanying notes are an integral part of these statements.

To the Stockholders and Board of Directors of Hershey Foods Corporation:

We have examined the consolidated balance sheets of Hershey Foods Corporation (a Delaware corporation) and subsidiaries as of December 31, 1977 and 1976, and the consolidated statements of income and retained earnings and changes in financial position for the years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying consolidated financial statements present fairly the financial position of Hershey Foods Corporation and subsidiaries as of December 31, 1977 and 1976, and the results of their operations and changes in their financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied during the periods.

ARTHUR ANDERSEN & CO.
New York, N.Y., February 15, 1978.

1. Summary of Significant Accounting Policies

The significant accounting policies followed by the Company, as summarized below, are in conformity with generally accepted accounting principles.

Principles of Consolidation—The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries after elimination of intercompany accounts and transactions. The accounts of Y & S Candies Inc., acquired November 30, 1977, are included on a pooling of interests basis and accordingly all prior period financial statements have been restated. The accounts and transactions of the Company's Canadian operations and foreign affiliates are translated in accordance with Financial Accounting Standards Board Statement No. 8. Charges and credits to income as a result of foreign currency translation are insignificant.

Inventories—Substantially all of the Chocolate and Confectionery Division (including Y & S Candies Inc.) inventories are valued under the "last-in, first-out" (LIFO) method. Such LIFO inventories amounted to approximately $41,296,000 in 1977 and $45,622,000 in 1976. Current cost, which approximates FIFO cost, exceeds LIFO cost by approximately $99,632,000 at December 31, 1977 and $47,959,000 at December 31, 1976. The remaining inventories are stated at the lower of cost or market under the "first-in, first-out" or "average cost" methods.

During 1977, the Company reduced inventory quantities, primarily cocoa beans. This reduction resulted in a liquidation of LIFO inventory quantities carried at lower costs prevailing in prior years as compared with the cost of 1977 purchases, the effect of which decreased cost of goods sold by approximately $8,500,000 and increased net income by approximately $4,000,000 or $.29 per share.

Depreciation—The Company and its subsidiaries follow the policy of providing for depreciation of buildings and improvements over estimated lives ranging from 20 to 50 years and of machinery and equipment over estimated lives ranging from 3 to 25 years. The companies have employed primarily straight-line methods in determining the annual charge for depreciation.

Major renewals and betterments are capitalized. Maintenance, repairs and minor renewals are expensed as incurred.

Goodwill—The excess cost of investments over net assets of the businesses acquired is carried as goodwill in the Consolidated Balance Sheets. It is the Company's policy to carry goodwill arising prior to November 1, 1970, at cost until such time as there may be evidence of diminution in value or the term of existence of such value becomes limited. Goodwill arising after October 31, 1970, is being amortized over a period not exceeding 40 years.

Other Assets—Investments include primarily the cost of less than majority owned companies and the applicable equity in earnings since acquisition.

Deferred location costs consist of certain expenses associated with the development and installation of new coffee service locations of Cory Food Services. These costs are deferred at the time of installation and are amortized over the life of the installation, but not to exceed four years.

Deferred development expenses at December 31, 1976, consist of soil and water conservation payments and other preoperating expenses relating to the development of almond ranches by L. D. Properties Corporation, a wholly-owned subsidiary of the Company, which was sold on June 30, 1977. Commencing in 1973, the first year of a substantial commercial harvest, the deferred expenses were being amortized on a straight-line basis over 18 years, which was the estimated commercially productive life of the almond trees.

Development and Promotion Expenses—The costs of research and development ($2,686,000 in 1977 and $2,229,000 in 1976) and advertising and promotion are expensed in the year incurred.

Income Taxes—Provision for Federal and state income taxes is based on income recorded in the financial statements. Deferred income taxes arise principally from the use of different methods of depreciation for tax and accounting purposes. The reduction in income taxes currently payable, resulting therefrom, is credited to deferred income taxes in the Balance Sheets. The provision for income taxes has been reduced by allowable investment tax credits.

Retirement Plan—The Company has retirement plans covering substantially all employees. The total pension expense was $5,832,000 in 1977 and $5,668,000 in 1976. The Company uses principally the entry age normal method of accounting for pension costs under which unfunded prior service costs, estimated at $51,850,000, will be funded over a 30 year period. The actuarily computed value of the vested benefits exceeds the assets of the plans by approximately $16,400,000.

Stockholders' Equity—On February 18, 1976, the Board of Directors approved a resolution to restate the value of common stock to $1.00 per share and adopted the policy of accounting for treasury shares as if retired. Additional paid-in capital arises from the acquisition of Y & S Candies Inc. and the exercise of stock options.

Net Income Per Share—Net income per common share has been computed based on the average shares of common stock outstanding during the period (13,722,147 in 1977 and 13,720,017 in 1976).

2. Acquisitions and Discontinued Operations

On November 30, 1977, Y & S Candies Inc. was acquired in exchange for 701,982 shares of common stock in a pooling of interests transaction. Y & S is a manufacturer of licorice-type candies.

During 1977, the Company acquired a 20% interest in the voting stock of AB Marabou of Sundbyberg, Sweden, the leading Scandinavian confectionery company, for $3,824,000.

Effective June 30, 1977, the real estate and operating equipment of the Company's wholly owned subsidiary, L. D. Properties Corporation, were sold to Tenneco West, Inc. for $20,000,000. This resulted in a net gain of $5,300,000 after taxes or $.39 per share.

Since the results for L. D. Properties for the first six months of 1977 were nominal, these amounts have been included in continuing operations. This operation, being agricultural, realized practically all of its income from almond crop sales after the harvest period beginning in September. The 1976 crop was sold in that year with no carry over to 1977 whereas there was some carry over of the 1975 crop to early 1976. Net sales, net income and net income per common share of the Company as previously reported have been adjusted to reflect the acquisition of Y & S Candies Inc. and the sale of L. D. Properties Corporation as follows:

	1976 (dollars in thousands)
Net Sales:	
As previously reported	$584,264
Adjustment for pooling of Y & S Candies Inc.	25,894
Adjustment for discontinued operations—L.D. Properties Corporation	(8,198)
As restated	$601,960
Net Income:	
As previously reported	$ 43,205
Adjustment for pooling of Y & S Candies Inc.	1,592
As restated	$ 44,797
Net income per common share:	
As previously reported	$ 3.32
As restated	$ 3.26

3. Income Taxes

The provision for income taxes from continuing operations exceeds taxes currently payable by $2,303,074 in 1977 and $1,171,658 in 1976, primarily because tax depreciation exceeds book depreciation as a result of using accelerated methods for tax purposes.

The following is a reconciliation of the provision for income taxes on continuing operations included in consolidated income and the amount computed by applying the Federal statutory rate to income before income taxes.

	1977 Amount	1977 %	1976 Amount	1976 %
Taxes computed at statutory rate	$34,262,212	48.0	$42,838,646	48.0
Increase (reductions) resulting from:				
State income taxes, net of Federal income tax benefit	3,052,820	4.3	3,646,454	4.1
Investment tax credit	(2,200,000)	(3.1)	(949,800)	(1.1)
Other, net	233,968	.3	26,700	.1
Provision for income taxes	$35,349,000	49.5	$45,562,000	51.1

4. Current and Long-Term Debt

Long-term debt at December 31, 1977 and 1976 consisted of the following:

	1977	1976
	(dollars in thousands)	
7¼% Sinking Fund Debentures due 1997 with annual payments of $1,500,000 beginning in 1978	$30,000	$30,000
Less—Debentures repurchased	(4,560)	(4,560)
6⅞% Industrial Revenue Bonds due 2000 through 2005	4,000	4,000
	$29,440	$29,440

The Company intends that the repurchased Debentures will be used to meet sinking fund requirements.

Industrial Revenue Bonds in the amount of $4,000,000 were issued on April 1,1975, by the Dauphin County Industrial Development Authority to provide financing for certain pollution control and environmental expenditures by the Company. The Company is solely responsible for payment of principal and interest. The unexpended balance of these funds is held by a Trustee.

As a result of seasonal working capital requirements, the Company maintains lines of credit of $60,000,000 with several domestic banks. There were no borrowings in 1977 or 1976 under these lines of credit.

Under these credit arrangements, there are no compensating balance agreements which legally restrict funds; however, the Company has been expected to and has generally maintained average compensating balances of 15% to 20% of borrowings or generally not less than 5% of commitments.

5. Lease Commitments

The Company rents and leases office space, automobiles and equipment, the aggregate annual cost of which is less than 1% of net sales. There are no material leases which are capitalizable under Financial Accounting Standards Board Statement No. 13.

6. Stock Option Plan

On November 30, 1977, a Hershey Foods Corporation Stock Option Plan was adopted as a substitute for the Y & S Candies Inc. 1970 Stock Option Plan pursuant to the Agreement and Plan of Merger between Y & S and the Company dated October 12, 1977. Under the Plan, at December 31, 1977, qualified and non-qualified stock options have been issued to key Y & S employees to purchase a maximum of 30,875 shares of the Company's common stock at prices ranging from $3.06 to $6.85. The Plan terminates on September 14, 1980, the last day outstanding options are exercisable. The exercise price per share of both qualified and non-qualified options outstanding has been adjusted by the exchange ratio used in the merger.

At December 31, 1977, no shares were available for future grant under the Plan. The excess of proceeds over the stated value of the stock issued under the Plan is credited to additional paid-in capital; no charge is made to income with respect to these options. During 1977, 10,102 shares were exercised under the Y & S Plan and Hershey Plan at prices ranging from $4.18 to $6.85.

7. Management Incentive Plan

The Company has a management incentive plan providing incentive compensation to eligible employees of the Company and its subsidiaries who have substantial managerial or similar responsibilities. The amount charged to expense was $901,000 in 1977 and $730,000 in 1976.

8. Industry Segments

The Company operates principally in two industry segments: Chocolate and Confectionery and Other Food Products and Services. Operations in the chocolate and confectionery industry involve production and sale of a full line of mass-distributed chocolate and confectionery products. The principal product groups sold are bar candy, bagged candy, chocolate drink mixes, baking ingredients, and dessert toppings. The Other Food Products and Services operations are involved in the operation of a coffee service plan for businesses and institutions, the manufacture and sale of coffee brewing equipment, and the manufacture and sale of pasta products.

Operating profit is total revenue less operating expenses. In computing operating profit, none of the following items has been added or deducted: general corporate expense, interest income-net, or income taxes. Depreciation for Chocolate and Confectionery and Other Food Products and Services for the year ended December 31, 1977 was $5,702,000 and $1,789,000, respectively. Capital expenditures were $22,381,000 and $3,014,000, respectively.

Identifiable assets are those assets that are used in the Company's operations in each industry. Corporate assets are principally cash and marketable securities of $117,239,000 and corporate property and equipment.

To reconcile industry information with consolidated information, $335,000 of intersegment sales have been eliminated. Virtually all intersegment sales to subsidiaries have been made at normal prevailing prices.

No customer, government or otherwise, constitutes 10% or more of sales. Foreign sales and assets constitute less than 10% of total sales and assets.

Information about the Company's operations in different industry segments for the year ended December 31, 1977 is as follows (dollars in thousands):

	Chocolate and Confectionery	Other Food Products and Services	Adj. and Elim.	Consolidated
Net sales to unaffiliated customers	$586,882	$84,345	$ —	$671,227
Intersegment sales	310	25	(335)	—
Total net sales	$587,192	$84,370	$(335)	$671,227
Operating profit	$ 69,834	$ 4,528		$ 74,362
General corporate expenses				(3,491)
Interest income-net				509
Income from continuing operations before taxes				$ 71,380
Identifiable assets at December 31,1977	$221,928	$47,023		$268,951
Corporate assets				127,202
Total assets at December 31, 1977				$396,153

9. Summary of Quarterly Data
(unaudited)

Dollars in thousands except per share figures

Year 1977	First	Second	Third	Fourth	Year
Net sales	$173,070	$124,117	$177,543	$196,497	$671,227
Gross margin	54,625	40,505	52,555	69,581	217,266
Income from continuing operations	8,778	4,820	8,221	14,212	36,031
Gain on sale of discontinued operations	—	5,300	—	—	5,300
Net income	$ 8,778	$ 10,120	$ 8,221	$ 14,212	$ 41,331
Net income per common share					
Continuing operations	$ .64	$ .35	$. 60	$1.03	$2.62
Gain on sale of discontinued operations	—	.39	—	—	.39
Net income per common share	$ .64	$ .74	$. 60	$1.03	$3.01

Year 1976	First	Second	Third	Fourth	Year
Net sales	$164,123	$113,616	$147,958	$176,263	$601,960
Gross margin	62,774	40,466	52,752	62,304	218,296
Income from continuing operations	14,738	6,934	11,076	10,937	43,685
Income (loss) from discontinued operations	15	107	(42)	1,032	1,112
Net income	$14,753	$ 7,041	$ 11,034	$ 11,969	$ 44,797
Net income per common share					
Continuing operations	$1.07	$ .51	$ .80	$ .80	$3.18
Discontinued operations	—	.01	—	.07	.08
Net income per common share	$1.07	$ .52	$ .80	$ .87	$3.26

Data previously reported for 1976 and the first three quarters of 1977 have been adjusted for the acquisition of Y & S Candies Inc. on a pooling of interests basis.

10. Impact of Inflation
(unaudited)

The Company's products and services have been subject in varying degrees to the inflation affecting the general economy and the goods and services purchased by the Company.

Since the major portion of inventories are costed at LIFO (last-in, first-out) the rapid escalation in product costs has been substantially reflected currently in cost of sales. The same situation does not exist with respect to plant and equipment and related depreciation charges. The cumulative impact of inflation over a number of years would result in replacement cost of existing plant and equipment and related depreciation being higher than actual historical cost.

Reference is made to the Annual Report Form 10-K (copy available on request) for additional information with respect to the estimated replacement cost of inventories and plant and equipment at December 31, 1977 and 1976, and the related estimated effect of such costs on cost of sales and depreciation expense for the years then ended.

Five-Year Financial Summary

Hershey Foods Corporation and Subsidiaries

(All of the figures have been adjusted to include the acquisition of Y & S Candies Inc. on a pooling of interests basis.)

(All dollar and share figures in thousands—except market price and per share statistics)

		1977	1976	1975	1974	1973
Summary of Earnings						
Continuing Operations						
Net Sales	$	671,227	601,960	576,165	511,083	432,113
Cost of Goods Sold	$	453,960	383,664	381,115	373,277	307,048
Operating Expenses	$	146,396	128,692	109,592	85,600	91,850
Interest Expense	$	2,422	2,240	3,126	3,710	5,814
Interest Income	$	2,931	1,883	1,862	1,431	918
Income Taxes	$	35,349	45,562	43,292	25,718	13,754
Income from Continuing Operations	$	36,031	43,685	40,902	24,209	14,565
Income (Loss) from Discontinued Operations	$	—	1,112	(1,457)	(1,608)	(8)
Gain (Loss) Related to Disposal of Discontinued Operations	$	5,300	—	(4,898)	—	—
Net Income	$	41,331	44,797	34,547	22,601	14,557
Net Income—Per Share of Common Stock						
Continuing Operations	$	2.62	3.18	2.99	1.77	1.06
Discontinued Operations	$	—	.08	(.11)	(.12)	—
Gain (Loss) Related to Disposal	$	.39	—	(.36)	—	—
Net Income	$	3.01	3.26	2.52	1.65	1.06
Dividends per—Common Share	$	1.14	1.03	.85	.80	1.10
Preferred Share	$	—	—	.60	.60	.60
Average Number of Common Shares and Equivalents Outstanding During the Year		13,722	13,720	13,698	13,685	13,686
Per Cent of Income from Continuing Operations to Sales		5.4%	7.3%	7.1%	4.7%	3.4%
Financial Statistics						
Capital Expenditures	$	27,535	20,722	10,542	11,084	18,167
Depreciation*	$	7,995	7,539	7,541	7,928	6,999
Advertising*	$	17,637	13,330	9,499	1,814	9,620
Current Assets	$	221,202	169,872	157,579	129,226	100,168
Current Liabilities	$	83,149	47,309	53,808	59,156	24,998
Working Capital	$	138,053	122,563	103,771	70,070	75,170
Current Ratio		2.7:1	3.6:1	2.9:1	2.2:1	4.0:1
Long-Term Debt	$	29,440	29,440	29,856	31,730	51,470
Debt-to-Equity Per Cent		11%	13%	15%	18%	31%
Stockholders' Equity	$	259,668	233,529	202,466	178,238	165,493
Stockholders' Data						
Outstanding Common Shares at Year-End		13,730	13,720	13,720	12,485	12,486
Market Price of Common Stock—						
At Year-End	$	19⅞	22⅜	18⅝	9¾	12⅝
Range During Year	$	16⅝–22⅜	18½–27½	10⅛–20⅞	8½–15	12½–24¾
Number of Common Stockholders		19,694	20,421	19,686	19,769	19,501
Employees' Data						
Payrolls	$	99,322	88,848	78,973	77,484	78,633
Number of Employees—Year-End		7,660	7,670	7,580	7,740	9,010

*Restated to reflect continuing operations only.

Officers

John S. Harkins
Vice President
Finance

Ogden C. Johnson
Vice President
Scientific Affairs

William P. Noyes
Vice President
Human Resources



Richard M. Marcks
Vice President
International

William F. Suhring
Vice President
Corporate Development

L. Whitley Simmons
Assistant Vice President
and Comptroller



Kenneth L. Wolfe
Treasurer

Earl J. Spangler
President, Hershey Chocolate
& Confectionery Division

James K. Morris
President
Hershey Chocolate of
Canada



Joseph P. Viviano
President
San Giorgio Macaroni, Inc.

George E. Wilber, Jr.
President
Cory Food Services, Inc.

Charles A. Smylie
President
Y & S Candies Inc.



Annual Meeting
The Annual Meeting will be held at 2 p.m. on Monday, April 24, 1978, at the Hershey Motor Lodge and Convention Center, Route 322 and University Drive, in Hershey.

A formal notice of this meeting, together with a proxy statement, will be mailed to stockholders on or about March 22, 1978.

Stockholders who are unable to attend the meeting are urged to sign and return their proxies promptly so the stock of the Company will be represented as fully as possible at the meeting.

Form 10-K
The Annual Report to the Securities and Exchange Commission on Form 10-K is available upon written request to the Secretary of the Corporation, 100 Mansion Road East, Hershey, Pa. 17033.

Principal Securities Market
The common stock is listed on the New York Stock Exchange.

Executive Offices
100 Mansion Road East
Hershey, Pa. 17033

Transfer Agent and Registrar
Manufacturers Hanover Trust Company
4 New York Plaza
New York, N.Y. 10015

Auditors
Arthur Andersen & Co.
New York

Board of Directors

H. S. Mohler, *Chairman*

W. E. C. Dearden, *Vice Chairman*

J. Hemphill
Director of Cocoa Bean Purchases of the Corporation

J. C. Jamison
Investment banker, Partner, Goldman, Sachs & Co.

S. A. Schreckengaust, Jr.
Vice President and General Counsel

P. A. Singleton
President, Singleton Associates International

L. C. Smith
Vice President, Engineering

J. C. Suerth
Chairman and Chief Executive Officer, Gerber Products Company

R. L. Uhrich
Vice President and Secretary

R. A. Zimmerman
President and Chief Operating Officer

Executive Committee

H. S. Mohler, *Chairman*

W. E. C. Dearden

S. A. Schreckengaust, Jr.

R. L. Uhrich

R. A. Zimmerman

Audit Committee

P. A. Singleton, *Chairman*

J. C. Jamison

J. C. Suerth

Compensation Committee

J. C. Jamison, *Chairman*

P. A. Singleton

J. C. Suerth

Employee Benefits Committee

S. A. Schreckengaust, Jr., *Chairman*

J. C. Jamison

P. A. Singleton

J. C. Suerth

Officers

H. S. Mohler
Chairman of the Board

W. E. C. Dearden
Vice Chairman of the Board and Chief Executive Officer

R. A. Zimmerman
President and Chief Operating Officer

J. S. Harkins
Vice President, Finance

O. C. Johnson
Vice President, Scientific Affairs

R. M. Marcks
Vice President, International

W. P. Noyes
Vice President, Human Resources

S. A. Schreckengaust, Jr.
Vice President and General Counsel

L. C. Smith
Vice President, Engineering

W. F. Suhring
Vice President, Corporate Development

R. L. Uhrich
Vice President and Secretary

K. L. Wolfe
Treasurer

L. W. Simmons
Assistant Vice President and Comptroller

Hershey Foods Corporation
Hershey, Pa. 17033 U.S.A.

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